



BUSINESS LAW SECTION

THE STATE BAR OF CALIFORNIA

Monday, October 28, 2002

Kathy Womack
Office of Law and Legislation
California Department of Corporations
1515 "K" Street, Suite 200
Sacramento, CA 95814-4052

Re: California Franchise Regulation 310.114.1 (c) 6. – Item 19

Dear Ms. Womack:

As you know, the Franchise Law Committee, a standing committee of the State Bar's Business Law Section, consists of California attorneys who practice extensively in the franchise law area and includes among its members attorneys who represent Franchisees, Franchisors or both. Representatives of your office have been invited to all of our meetings and at least one representative has chosen to attend a number of our meetings and has been in regular contact with us on matters of mutual interest.

The Franchise Law Committee's mission includes commenting on and proposing legislative and regulatory changes affecting franchising. This letter presents comments and suggestions on behalf of our Committee with respect to proposed Reg. 310.114.1 (c) 6., relating to Item 19 of the Uniform Franchise Offering Circular.

Background

The proposed regulation addresses the situation where a Franchisor wishes to provide prospective Franchisees with information regarding financial results of operations at franchised and/or non-franchised ("company-owned") units, but does not, or cannot, provide costs of sales or operating expenses.

All other states permit Franchisors to make an Item 19 statement containing only gross sales information, without accompanying costs of sales or operating expenses. Until recently, California franchise examiners followed this practice. Last spring, however, California franchise examiners started rejecting Item 19 statements which failed to include costs of sales or operating expenses. California stands alone as the only state that takes this approach.

We are gratified to see the DOC's proposed rule on Item 19, which goes a long way to bring California back into the mainstream. Our Committee generally supports the proposed regulation subject to the following technical changes.

Recommended Changes

1. In the second line, we recommend adding the words "unless the earnings claim figures include either" before "costs of sales or operating expenses." This clarifies that a franchisor need not include the required statement if its Item 19 includes either costs of sales or operating expenses.

2. As with other California-specific disclosures, it should be sufficient for a franchisor to make the required Item 19 statement either in the body of Item 19 itself or in an addendum or appendix to the UFOC.

3. We read the proposed rule to permit a franchisor to make an Item 19 disclosure *without* the mandatory statement if any cost or expense data is included in the Item 19. The proposed rule does not specify any specific kind of cost or expense data. If the DOC disagrees with our reading of the proposed rule, it should clarify the rule to address this point.

4. References to "net income or profit" should be modified, since other factors (e.g. interest, taxes, depreciation, amortization, and other non-operating charges, among others) in addition to costs of sales and operating expenses need to be subtracted from gross revenues or gross sales to arrive at net income or profit. In lieu of "net income or profit," we suggest using "income or profit."

5. We disagree that franchisees and former franchisees may be the "best" source of cost and expense data. Many franchisors will advise you that existing and former franchisees are not a reliable source for collecting this data for any number of reasons. Some franchisees may keep family members on the payroll at inflated wage levels while others may use the franchise business to pay for questionable business-related expenses, such as automobile, entertainment and home office use. These factors, among others, may create significant variances among franchisees with respect to their operating costs and expenses that a prospective franchisee may not be able to evaluate. Furthermore, many franchisors will tell you that existing and former franchisees will not share their cost or expense data with prospects for any number of reasons, including privacy concerns. The UFOC requires disclosure of contact information for franchisees and recent former franchisees. Prospective franchisees can contact these owners to investigate the franchise and obtain cost and expense data from them. Therefore, the statement that franchisees and former franchisees may be the "best" source of this information is both inaccurate and potentially misleading and should be deleted.

6. We recommend that the reference to Item 20B. be modified as shown below since UFOC Items are not sub-numbered and the roster of franchisees and former franchisees is often in an exhibit.

Our committee recommends revising the proposed regulation as follows (changes are indicated in italics):

Initially Proposed Version.

Item 19: If an earnings claim is made, and the earnings claim figure(s) does (do) not include costs of sales or operating expenses, then, in addition to the information required by Item 19, all offering circulars shall contain the following statement prominently set forth in Item 19: "The earnings claims figure(s) does (do) not reflect the costs of sales or operating expenses that must be deducted from the gross revenue or gross sales figures to obtain your net income or profit. The best source of cost or expense data may be from franchisees and former franchisees, some of whom may be listed in Item 20B."

Suggested Revised Version.

Item 19: If an earnings claim is made, unless the earnings claim figures include *either* costs of sales or operating expenses, then, in addition to the information required by Item 19, all offering circulars shall contain the following statement prominently set forth in Item 19 *or in an addendum or appendix to the Offering Circular*: "The earnings claims figure(s) does (do) not reflect the costs of sales or operating expenses that must be deducted from the gross revenue or gross sales figures to obtain income or profit. *[omission]* Cost or expense data may be *available* from franchisees and former franchisees, some of whom may be listed in *the Offering Circular*."

We appreciate the opportunity to offer our suggestions. Please contact either of us if you have any questions or need any further information. We look forward to working with you and other members of the Department on this and other matters.

Sincerely,
CALIFORNIA FRANCHISE LAW COMMITTEE

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